1977

Client representations; Statement on auditing standards, 019

American Institute of Certified Public Accountants. Auditing Standards Executive Committee

Statement on Auditing Standards

June 1977

19

Issued by the Auditing Standards Executive Committee

AICPA American Institute of Certified Public Accountants

Client Representations

1. This Statement establishes a requirement that the independent auditor obtain certain written representations from management as a part of an examination made in accordance with generally accepted auditing standards and provides guidance concerning the representations to be obtained.

Reliance on Management Representations

2. During an examination, management makes many representations to the auditor, both oral and written, in response to specific inquiries or through the financial statements. Such representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for his opinion on the financial statements. Written representations from management ordinarily confirm oral representations given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations.

3. The auditor obtains written representations from management relating to its knowledge or intent when he believes they are necessary to complement his other auditing procedures. In many cases, the auditor applies auditing procedures specifically designed to

obtain corroborating information concerning matters that are also the subject of written representations. For example, after the auditor performs the procedures prescribed in Statement on Auditing Standards No. 6, *Related Party Transactions*, even if the results of those procedures indicate that transactions with related parties have been properly disclosed, he should obtain a written representation to document that management has no knowledge of any such transactions that have not been disclosed. In some cases involving written representations, the corroborating information that can be obtained by the application of auditing procedures other than inquiry is limited. When a client plans to discontinue a line of business, for example, the auditor may not be able to obtain information through other auditing procedures to corroborate the plan or intent. Accordingly, the auditor should obtain a written representation to provide confirmation of management's intent. Unless the auditor's examination reveals evidential matter to the contrary, his reliance on the truthfulness of management's representations is reasonable.[1]

Obtaining Written Representations[2]

4. The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. They ordinarily include the following matters, if applicable:

a. Management's acknowledgment of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles or other comprehensive basis of accounting.
b. Availability of all financial records and related data.
c. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors.
d. Absence of errors in the financial statements and unrecorded transactions.
e. Information concerning related party transactions and related amounts receivable or payable.[3]

---

[1] See SAS No. 16, paragraphs 9 and 10.
[2] An illustrative representation letter from management is contained in the Appendix.
[3] See SAS No. 6.

f. Noncompliance with aspects of contractual agreements that may affect the financial statements.
g. Information concerning subsequent events.[4]
h. Irregularities involving management or employees.[5]
i. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.
j. Plans or intentions that may affect the carrying value or classification of assets or liabilities.
k. Disclosure of compensating balance or other arrangements involving restrictions on cash balances, and disclosure of line-of-credit or similar arrangements.
l. Reduction of excess or obsolete inventories to net realizable value.
m. Losses from sales commitments.
n. Satisfactory title to assets, liens on assets, and assets pledged as collateral.
o. Agreements to repurchase assets previously sold.
p. Losses from purchase commitments for inventory quantities in excess of requirements or at prices in excess of market.
q. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.[6]
r. Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5.[7]
s. Unasserted claims or assessments that the client's lawyer has advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.[8]
t. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.

5. Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on the limits of materiality for this purpose. Such limitations would not apply to those representations that are not directly related to amounts included in the financial statements, for example, items (a), (b), and (c) above. In addition, because of the possible effects of irregularities on other aspects of the auditor's examination, a materiality limit would not apply to item (h) above

[4] See SAS No. 1, sections 560.12 and 710.08.
[5] See SAS No. 16.
[6] See SAS No. 17.
[7] See SAS No. 12, paragraph 5.
[8] See SAS No. 12, paragraph 5.

with respect to management and those personnel who have significant roles in the system of internal accounting control.

6. In addition to matters such as those indicated above, the auditor may determine, based on the circumstances of the engagement, that other matters should be specifically included in written representations from management.[9] For example, if a company excludes a short-term obligation from current liabilities because it intends to refinance the obligation on a long-term basis, the auditor should obtain a specific representation of management's intent to consummate the refinancing.[10] Also, the auditor should obtain written representations concerning unaudited replacement cost information and interim financial information included in audited financial statements.

7. In certain instances, the auditor may request other written representations from management in addition to evidential matter obtained through other procedures. For example, although the auditor may be satisfied with the method of pricing inventories, he may ask management to furnish a representation concerning inventory pricing.

8. If the independent auditor is reporting on consolidated financial statements, the written representations obtained from the parent company's management should specify that they pertain to the consolidated financial statements and, if applicable, to the separate financial statements of the parent company.

9. The written representations should be addressed to the auditor. Because the auditor is concerned with events occurring through the date of his report that may require adjustment to or disclosure in the financial statements, the representations should be dated as of the date of the auditor's report. They should be signed by members of management whom the auditor believes are responsible for and knowledgeable, directly or through others in the organization, about

[9] Certain AICPA audit guides require or recommend that the auditor obtain written representations concerning matters that are unique to a particular industry. This Statement does not supersede those requirements or recommendations.

[10] See Statement of Financial Accounting Standards No. 6, paragraphs 9 through 11.

the matters covered by the representations. Normally, the chief executive officer and chief financial officer should sign the representations.

10. In certain circumstances, the auditor may want to obtain written representations from other individuals. For example, he may want to obtain written representations about the completeness of the minutes of the meetings of stockholders, directors, and committees of directors from the person responsible for keeping such minutes. Also, if the independent auditor examines the financial statements of a subsidiary but does not examine those of the parent company, he may want to obtain representations from management of the parent company concerning matters that may affect the subsidiary, such as related party transactions or the parent company's intention to provide continuing financial support to the subsidiary.

Scope Limitations[11]

11. Management's refusal to furnish a written representation that the auditor believes is essential constitutes a limitation on the scope of the auditor's examination sufficient to preclude an unqualified opinion. Further, the auditor should consider the effects of management's refusal on his ability to rely on other of their representations.

12. If the auditor is precluded from performing procedures he considers necessary in the circumstances with respect to a matter that is material to the financial statements, even though he has been given representations from management concerning the matter, there is a limitation on the scope of his examination, and he should qualify his opinion or disclaim an opinion.

Effective Date

13. Statements on Auditing Standards generally are effective at the time of their issuance. However, since this Statement provides

[11] See SAS No. 2, paragraphs 10 through 12.

for practices that may differ in certain respects from practices heretofore considered acceptable, *this Statement will be effective* for examinations made in accordance with generally accepted auditing standards for periods ending on or after September 30, 1977.

Appendix

Illustrative Representation Letter

The following letter is presented for illustrative purposes only. The written representations to be obtained should be based on the circumstances of the engagement and the nature and basis of presentation of the financial statements being examined. The introductory paragraph should specify the financial statements and periods covered by the auditor's report, for example, "balance sheets of XYZ Company as of December 31, 19X1 and 19X0, and the related statements of income and retained earnings and changes in financial position for the years then ended." Similarly, representations concerning inventories and sales and purchase commitments would not be obtained if such items are not material to the company's financial position and results of operations or if they are not recorded in the financial statements under a comprehensive basis of accounting other than generally accepted accounting principles, for example, financial statements prepared on the cash basis of accounting.

The illustrative letter assumes that there are no matters requiring specific disclosure to the auditor. If such matters exist, they should be indicated by listing them following the representation, by reference to accounting records or financial statements, or by other similar means. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, item 14 could be modified as follows: "Except as discussed in Note X to the financial statements, no events have occurred. . . ." Similarly, in appropriate circumstances, item 4 could be modified as follows: "We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except that certain marketable securities have been excluded from current assets based on our intention not to dispose of them, which is supported by the minutes of the December 7, 19X1, meeting of the board of directors."

Certain terms are used in the illustrative letter that are defined elsewhere in authoritative literature, for example, irregularities (SAS No. 16) and related party transactions (SAS No. 6). To avoid misunderstanding concerning the meaning of such terms, the auditor may wish to furnish those definitions to the client and request that the client include the definitions in the written representations.

The illustrative letter assumes that management and the auditor have reached an understanding on the limits of materiality for purposes of the written representations. However, it should be noted that a materiality limit would not apply for certain representations, as explained in paragraph 5 of this Statement.

(Date of Auditor's Report)

(To Independent Auditor)

In connection with your examination of the (identification of financial statements) of (name of client) as of (date) and for the (period of examination) for the purpose of expressing an opinion as to whether the (consolidated) financial statements present fairly the financial position, results of operations, and changes in financial position of (name of client) in conformity with generally accepted accounting principles (other comprehensive basis of accounting), we confirm, to the best of our knowledge and belief, the following representations made to you during your examination.

1. We are responsible for the fair presentation in the (consolidated) financial statements of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles (other comprehensive basis of accounting).

2. We have made available to you all—
   a. Financial records and related data.
   b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

3. There have been no—
   a. Irregularities involving management or employees who have significant roles in the system of internal accounting control.
   b. Irregularities involving other employees that could have a material effect on the financial statements.
   c. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.

4. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

5. The following have been properly recorded or disclosed in the financial statements:
   a. Related party transactions and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.
   b. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.
   c. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line-of-credit or similar arrangements.
   d. Agreements to repurchase assets previously sold.

6. There are no—
   a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
   b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5.

7. There are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.

8. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.

9. Provision, when material, has been made to reduce excess or obsolete inventories to their estimated net realizable value.

10. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.

11. Provision has been made for any material loss to be sustained in the fulfillment of, or from inability to fulfill, any sales commitments.

12. Provision has been made for any material loss to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices.

13. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

14. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

____
(Name of Chief Executive
Officer and Title)

____
(Name of Chief Financial
Officer and Title)

The Statement entitled Client Representations *was adopted unanimously by the twenty members of the Committee, of whom one, Mr. Lamb, assented with qualification.*

Mr. Lamb assents to the issuance of this Statement but qualifies his assent with respect to paragraph 2. He agrees with the view expressed in that paragraph that obtaining representations from management does not make applying other auditing procedures unnecessary. He objects to the paragraph, however, because he believes that it conveys the erroneous impression that an auditor can always corroborate a representation made by management. In Mr. Lamb's judgment, this flaw in paragraph 2 is confirmed rather than overcome by the example in paragraph 3 of an instance wherein an auditor may not be able, by applying auditing procedures, to corroborate management's representation concerning an intent to discontinue a line of business.

Auditing Standards Executive Committee (1976-1977)

PHILIP B. CHENOK, *Chairman*
WILLIAM J. BADECKER
JAMES E. COMMONS
J. MICHAEL COOK
BRUCE D. DIXON
JAMES J. GRIFFERTY
HOWARD GROVEMAN
HERBERT M. HABER
JOHN G. HENDERSON
GERALD W. HEPP
JAMES I. KONKEL
EDWIN M. LAMB
LEROY E. MARTIN
ALAN MAY, JR.
ROBERT L. MAY
HARVEY D. MOSKOWITZ
STAN ROSS
ROBERT E. ROSSEL
KENNETH I. SOLOMON
JOHN J. WILLINGHAM

THOMAS P. KELLEY, *Director Auditing Standards*
MARY LYNN O'NEILL, *Manager Auditing Standards*

Note: *Statements on Auditing Standards are issued by the Auditing Standards Executive Committee, the senior technical committee of the Institute designated to issue pronouncements on auditing matters. Rule 202 of the Institute's Code of Professional Ethics requires adherence to the applicable generally accepted auditing standards promulgated by the Institute. It recognizes Statements on Auditing Standards as interpretations of generally accepted auditing standards and requires that members be prepared to justify departures from such Statements.*